IN THE

UNITED STATES COURT OF APPEALS FOR

THE NINTH CIRCUIT

JOHN G. GROVES, Trustee Appellant, vs. FRESNO GUARANTEE SAVINGS AND LOAN ASSOCIATION, Appellee,	)	NO. 20,581

APPELLANT'S CLOSING BRIEF

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Attorneys for Appellant

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RESTATEMENT OF THE CASE

Appellee's Statement of the Case is in error. The only facts before this court on appeal and the only facts that were before the District Court on review are those found and set forth by the Referee (Findings, R. 20-22). Neither Appellee nor Appellant have ever challenged these Findings, and thus no Reporter's Transcript was ever prepared or filed on review or appeal.

At page 2 of its Brief, Appellee asserts that by October 2, 1964 it "had assumed practically full charge of the operation of the premises and was collecting the rents (R. 36-37)." The portion of the Record on Appeal cited for this assertion is the District Court's Memorandum Order, for which there is no support in the Findings. As a matter of fact, the Finding on the subject (VIII, R. 22) recites: "That no rents were collected either by the debtor after the filing of the notice of default by respondent and prior to the filing of the petition in bankruptcy herein, and that no rent became due during said period."

Appellee bases part of its argument, e.g. page 7 of its Brief, on the existence of a demand for possession. The facts are: (1) the partnership, debtor-bankrupt, was the trustor by a deed of trust to Appellee (Exhibit E), (2) the partnership was represented at the premises of the apartment building by its managing partner, one John Azlant. (Finding VI, R. 21-22), and (3) Appellee never made any demand whatever on the trustor partnership for possession of the

apartment house. The Findings of Fact are absolutely silent on the question of such demand, and the Findings negate any implication that demand was so made prior to 4:26 o'clock p. m., September 30, 1964, or thereafter.

Finally, Appellee must be credited with a correct statement of the fair market value of the apartment building - $760,000.00 - and a correct statement of the sum secured by its deed of trust - $592,000.00. Obviously, the Appellee had a margin of safety or excess value to its security in the approximate amount of $167,000.00.

QUESTION PRESENTED

Appellee has side-stepped the issue. The Appellee's Reply Brief fails to develop a clash with the Opening Brief, and it fails to assist the court to understand the basic controversy. The question presented to this court is, simply, whether Appellee obtained a valid lien in the rentals before the Bankruptcy Court acquired exclusive jurisdiction over the property on September 30, 1964.

Appellee would have court and counsel believe that the issue is whether it could collect the rents and continue collecting them after the decision below, "subject to accountability for them." See "Question Presented," Appellee's Brief, p. 4. Appellee ignores reality in assuming that the question of its "accountability" could be determined without resolution by this court of the issue of the validity of Appellee's lien in the rentals, collected and held by Appellee.

The focal point of the question presented is the Referee's Conclusion of Law II,

> "That respondent, Fresno Guarantee Savings & Loan Association, did take action prior to September 30, 1964 to commence enforcement of the assignment of rents clause contained in the deed of trust described hereinabove. That by virtue thereof, said respondent is entitled to the rents from said premises."

Appellant contends this conclusion was erroneous.

ARGUMENT

A. INTRODUCTION

The best explanation of Appellee's failure to meet the issue is that the Referee erred in concluding that the assignment of rents was effective. The comparison made in the Opening Brief, pp. 8-9, of the facts here and in Malsman v. Brandler, 230 Cal. App. 2d 922, 41 Cal. Rptr. 439 (1964), leaves no doubt that Appellee's assignment of rents was not perfected under California law before September 30, 1964.

Appellee has divided its Reply Brief into five arguments. These five arguments will be answered in part B. hereof, "Rebuttal", giving the same sub-numbers to the corresponding portions of Appellee's Reply Brief.

B. REBUTTAL

I. THE BANKRUPTCY COURT'S DECISION WAS INCONSISTENT WITH CALIFORNIA LAW.

The argument, which appears in Appellee's Reply Brief, pp. 6-9, boils down to the assertion: "it can reasonably be inferred from the record as a whole that appellee had de facto possession of the property at all times while the rents in dispute were being collected." Id., p. 8. The quoted statement is not only

presumptuous, it is misleading. It presumes that this court may draw an inference in conflict with the express, unchallenged Findings of Fact. It tends to mislead the court to the view that possession after September 30, 1964 is material to the disputed issue. The Findings establish that no rents were collected until after September 30, 1964, and it is therefore obvious that Appellee was arguing about de facto possession after that all-important date when the petition in bankruptcy was filed.

Appellee has also restated the rule that a demand for possession entitles the mortgagee to pledged rentals, citing Title Guarantee & Trust Co. v. Monson, 11 Cal. 2d, 621, 81 p. 2d 944 (1938), and Mortgage Guaranty Co. v. Sampsell, 51 Cal App. 2d 180, 124 P. 2d 180, 124 P. 2d 353 (1942). This is the law of California, but it is not applicable to the case at bench, since Appellee never so demanded possession.

This rule serves, however, to illustrate how Appellee dramatically failed to perfect its security. If Appellee had made such a demand upon the partnership before September 30, 1964, Appellee would have legally obtained the rents. Throughout its Brief, Appellee urges that it actively asserted its right to receive the rents, but as a matter of fact Appellee failed to take the easiest, most elementary step - it failed to demand of the partnership possession of the apartment house.

Again, in its attempt to distinguish Malsman v. Brandler, supra (Appelee's Brief, pp. 7-8), Appellee has ignored the significant

date when the petition was filed. Its argument that it collected rents pursuant to an ex parte order pendente lite is probative of nothing, especially when the collections were made after the last date Appellee could have perfected its security. Moreover, one of the lessons of the Malsman case itself is that a demand for rents is not effective.

II. THE BANKRUPTCY COURT'S DECISION IS NOT SUPPORTED BY PRIOR RULINGS OF THIS COURT.

The corresponding section of Appellee's brief is mainly an extensive quotation from Judge Pope's scholarly opinion for this court in Pollack v. Sampsell, 174 F. 2d 415 (9th Cir. 1949). There are two distinct and unrelated reasons why this court's opinion in the Pollack case does not support the decision below: (1) in Pollack v. Sampsell the mortgagee had established that there was a deficiency due on its claim, 174 F. 2d at 417, and (2) in Pollack v. Sampsell the court was not faced with the objection that its decision was contrary to State law and therefore in conflict with Erie R. Co. v. Tompkins, 304 U.S. 64 (1938).

Pollack v. Sampsell involved a real property mortgage, and the controversy was over proceeds of a crop grown on the pledged real property. It was proven that there was a "deficiency in excess of the amount for which the crop had been sold." 174 F. 2d at 417. For this reason, standing alone, the Pollack case has no application to the present appeal, where the real property apart

from its rents and issues was of a value $167,000.00 in excess of the secured balance due Appellee. The significance of this fact is underscored by Appellee's ex parte Petition, presented to Honorable M. D. Crocker, District Judge, on October 5, 1964.

This Petition was made part of the Record on Appeal as a supplemental record. At page 4 of that Petition, the present Appellee made the following representation to the Bankruptcy Court:

> "7. Petitioner is informed and believes, and therefore alleges, that the fair market value of said premises does not exceed the total indebtedness of debtor to petitioner which is secured by said deed of trust . . . . "

Of course, upon the trial of the Order to Show Cause, this representation was proven false, as were many other representations in the same Petition. The point of mentioning this at all is that Appellee itself recognizes that an essential basis for its claim to the rents was that it would otherwise be left with a deficiency.

The second reason Pollack v. Sampsell does not control is that the result there reached was that required by State law. See 174 F. 2d at 421, N. 4, and Opening Brief, p. 15. The unharvested crops were by virtue of state law charged with the lien of the mortgagee of the land. Therefore, the question of the Erie doctrine in bankruptcy was not reached by the court. Appellee has chosen to completely ignore the application of Erie R. Co. v. Tompkins to its reliance upon the language in Pollack v. Sampsell. Again, Appellee seeks to avoid the issue. By reason of this failure of Appellee to brief

the Erie question, Appellant will not here reiterate the original discussion in the Opening Brief, pp. 12-14.

It must, however, be observed that the equitable principles discussed in Pollack, in IV Collier on Bankruptcy 1044-1056 (14th ed. 1964), and throughout Appellee's Reply Brief should be applied only when they do not generate consequences different from those which obtain under State law. If these doctrines are ever to be applied (contrary to their application in Pollack) to accord a mortgagee greater security than he would have under State law, they should be invoked by the bankruptcy court to alleviate a deficiency, not to grant a windfall. See In re Cigar Stores Realty Holdings, Inc., 69 F. 2d 823 (2nd Cir. 1934).

III. THE BANKRUPTCY COURT DID NOT CORRECTLY APPLY EQUITABLE PRINCIPLES

Appellee, presumably with tongue in cheek, asserts that the Opening Brief spoke for "the ghost of the bankrupt partnership." Reply Brief, P. 14. The remark belies Appellee's labored effort to avoid the issue, namely, whether its assignment of rents was perfected before bankruptcy. The issue would be the same if the partnership had filed a petition for liquidation, "straight bankruptcy", rather than for an arrangement.

Special equities, however, do arise because the partnership-debtor was proceeding under Chapter XI. That is, until the proposed plan of arrangement could be confirmed or found not feasible, and in the event of confirmation, it was essential to debtor that it have operating income. In light of the court's finding that the apartment house was worth $167,000.00 more than the amount due Appellee, what equitable principle commands the bankruptcy court to destroy a plan of arrangement by denying the debtor any income from the apartment building? Appellee has cited no authority for such a principle of equity.

The Appellee's argument at pages 15-17 of its Brief is based upon an extreme distortion of the issue presented by this appeal. That argument contends that a stay of foreclosure was equitable only when the court gave the rents to Appellee. No authority is cited for this contention, which has no support in logic. The perfection of the

pledge made of rents in the trust deed has no connection with the propriety of staying foreclosure proceedings. If foreclosure had not been stayed, the court would still have the same question before it, namely, whether Appellee was entitled to rents collected before the foreclosure sale.

The Bankruptcy Court did not correctly apply the equitable principles, since there was no deficiency owing to Appellee. Appellee has not filed a deficiency claim (see certified copy of Claims Register, sent up with Record on Appeal), and the Findings (R. 21) contradict any conceivable inference there was a deficiency. The proof of a deficiency made in Pollack v. Sampsell, supra, has already been cited. 174 F2d at 417. Moreover, the prime authority cited by Appellee, Mortgage Loan Co. v. Livingston, 45 F. 2d 28 (8th Cir. 1930), was a case where the mortgages had proved their deficiency was the sum of $35,000.00. 45 F. 2d at 31.

IV. THE ORDER BELOW WAS NOT A SEQUESTRATION ORDER.

Appellee would have this court overlook the pleadings which framed the issues in the trial court. The initial pleading was the partnership's Petition for Order to Show Cause (R. 11-12), filed on October 2, 1964. The reply was Appellee's Answer to Petition for Order to Show Cause (a part of the Supplemental Record on Appeal), filed on October 14, 1964. The petition prayed for an order that Appellee show cause why the Bankruptcy Court "should not determine the nature, extent and validity of" Appellee's lien (R. 12).

The Answer of Appellee set up the following matters in defense: (1) that the deed of trust contained the assignment of rents clause quoted in the Opening Brief, p. 8, (2) that Appellee had been, on September 25, 1964 and thereafter, in "exclusive possession of said property," and (3) that the debtor's equity in the property was then worthless. The Answer set up no equitable defenses and did not seek sequestration of the rents. Moreover, the Answer was an implicit admission that Appellee was flagrantly in contempt of court by its violation of the restraining order set forth on page two, lines 10-18 of the Order to Show Cause (R. 7), until the Order Modifying Temporary Restraining Order (R. 16) was signed by Judge Crocker on October 5, 1964.

In any event, the Appellee has never sought sequestration of the rents. It has only relied on the perfection of its

assignment of rents clause, as far as the record reflects its attempts to obtain the rents by lawful means.

At page 17 of its Reply Brief, Appellee declares that the mortgagees in Pollack v. Sampsell, 174 F.2d 415 (9th Cir. 1949), and Mortgage Loan Co. v. Livingston, 45 F.2d 28 (8th Cir. 1930), made no application for a sequestration order. In the Livingston opinion the court stated that the mortgagee made such an application on October 24, 1927. 45 F.2d at 30, 2nd col. In the Pollack case, such application was unnecessary because the real property mortgagee had a perfected, valid, and prior lien in the unharvested orange crop at the date the bankruptcy petition was filed. 174 F.2d at 419, 2nd. col. And, of course, in both cases the mortgagees had established undisputed deficiencies.

Appellee concedes that it is entitled to the rents only to the extent it can prove a deficiency. See Reply Brief, p. 18. This is a rather large concession in light of its earlier argument that it was entitled to the rents by force of post-bankruptcy, de facto possession. Reply Brief, p. 8. By its own concession, Appellee is not entitled to the rents, for it has no deficiency. Assuming that at this late date Appellee moved to sequester the rents upon a showing of a deficiency, the rents in controversy would not be affected, since only the rents falling due after filing the petition for sequestration are subject to such claim. Investors Syndicate v. Smith, 105 F.2d 611, 621-622 (9th Cir. 1939); In re Humeston, 83 F.2d 187 (2nd Cir. 1936).

Appellee, in its Brief, p. 19, seems also to maintain that the modified restraining order was a sequestration of rents. That order was obtained ex parte on a verified petition which alleged that Appellee had obtained possession of the apartment building on or about September 24, 1964 (Petition, etc., p. 2, Supplemental Record on Appeal). These allegations were found untrue by the Referee and the District Court on review. The possession achieved by Appellee through the device of this ex parte modification did not effect a sequestration of rents for its benefit, since Appellee was thereby to collect the rents "accountable to this Court" (R. 17, line 24). The modification could not be deemed to have given Appellee any substantive rights, since Appellant's predecessor in interest had no opportunity to be heard in those proceedings.

V. THE BANKRUPTCY ESTATE HAS LOST THE RENTS IN QUESTION BY THE ORDER APPEALED FROM.

Appellee's last major contention is that the bankruptcy estate had nothing to lose by the award of rents to Appellee during the proceedings. The burden and direction of this argument is obscure. This argument concedes that this court, in the event the District Court's order is affirmed, should remand the cause to the Bankruptcy Court for an accounting under the Order Modifying Temporary Restraining Order of October 4, 1964 (R. 16). Yet, Appellee claims it is entitled to what it terms "net rents." Reply Brief, p. 21.

The contention that the "result in terms of net asset values added to the estate would be the same as if appellant himself had received the rents," Ibid., is erroneous. First, the rents are presently lost for purposes of payments of costs of administration of the bankruptcy estate and taxes. Such expenses are properly deducted, even when the rents are validly sequestered. Florida Nat. Bank of Jacksonville v. United States, 87 F.2d 896 (5th Cir. 1937). Second there were two other liens upon the subject property whose holders would receive the first benefit of any reduction of the amount first secured to Appellee (Findings, R. 21).

Third, Appellee ignores the economic reality of the market for sale of interests owned by bankrupts and insolvent estates. The fact of the matter is that a bankruptcy estate can rarely realize

the fair market value of its equity in mortgaged property, since any potential buyer would prefer to await the foreclosure sale for the lower price. In the present case, foreclosure was pending and imminent during the period that Appellant owned the bankrupt's equity. Fourth, Appellee's claim, that it should have the rents because it could not matter who received them, militates just as strongly against Appellee's position. There is no reason, where as here the mortgage is fully secured, to give the mortgagee the rents and place the risk of the marketplace upon the trustee in bankruptcy. Certainly, such a course is insensible where, as here, the mortgagee has no perfected security interest in rents.

C. CONCLUSION

The Appellee here, unlike the real property mortgagee in Pollack v. Sampsell, supra, did not have a valid lien in the rents at the time the petition in bankruptcy was filed. The property then became in custodia legis from the filing of the petition. It followed that a lien in the rents could not "thereafter be obtained nor proceedings be had in other courts to reach the property . . . " Stratton v. New, 283 U. S. 318, 321 (1930).

The equitable defenses, which were never raised by the petition to sequester or in the Answer to Petition for Order to Show Cause, are inappropriate for that reason and because Appellee had no deficiency. It is therefore urged that the lower court's decision be reversed with directions to remand the cause to the bankruptcy court for further proceedings consistent with the ruling the Appellee has no lien in the rents in question.

Respectfully submitted,

FULLERTON, LANG & RICHERT

By_____
William T. Richert
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JOHN G. GROVES, Trustee

ATTORNEY'S CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated and executed this 27th day of June, 1966.

WILLIAM T. RICHERT